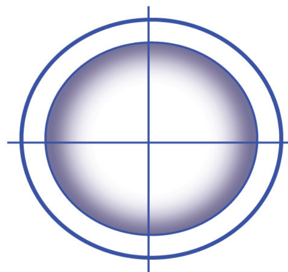

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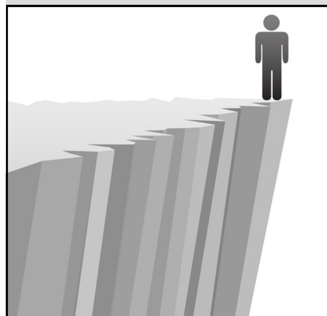
Understanding the Fiscal Cliff

What Is It? Possible Effects? Options & Outlook?

July 25, 2012 by William L. Pittenger, MAI, SRA

The "Fiscal Cliff" is a popular term used to describe the financial conundrum the federal government will face beginning at year end. The situation was created by law in the summer of 2011 following the failure of the presidentially appointed bi-partisan *Super Committee* to agree on a deficit reduction plan. Republicans wanted to cut spending and not raise taxes. Democrats wanted a combination of spending cuts and increased taxes. In what was thought to be an unlikely scenario at the time, a variety of automatic tax increases and spending cuts were agreed upon in case the Super Committee failed. The automatic measures included enough pain for both parties so that incentive would be created to reach agreement. Nevertheless, it failed.

The Super Committee failure meant that the automatic deficit reduction measures would kick in beginning at the end of 2012. None of them are politically popular and all of them, if implemented as scheduled, will be like falling off a (fiscal) cliff into recession. Hence the term.



The concept is simple yet even deciding on the potential impact is not. Some of the impact numbers being touted refer to the impact in 2013 and others take into account the impact for a decade. There is little agreement on precisely what the numbers are nor their full impact. A one year estimate may not include everything and a lot can happen to change or derail the plan over 10 years rendering both estimates suspect.

On the tax side, the Bush era tax cuts are scheduled to expire on January 1st. An estimated $340 billion would be pulled out of the economy in 2013 and 2014 after the tax cuts sunset. The effect between 2013 and 2022 is estimated to be $2.8 trillion. Another $90 billion would come out of the economy in 2012 with the December 31, 2012 expiration of the Obama era payroll tax holiday and $25 billion more from expiration of emergency unemployment benefits. The Alternative Minimum Tax (AMT) so-called "patch" will increase taxes $90 billion in 2013 and $805 billion between 2013 and 2022. Other effective tax increases will occur by raising the capital gains tax to 20%; eliminating the 10% bracket; cutting the child care credit in half and much more. Moreover, tax increases driven by the new healthcare law will begin to take effect in 2013 and for years thereafter.

On the spending side, defense spending would be reduced 10% or $30 billion in 2013 and as much as $510 billion over time. Medicare providers would take a two-percent reduction (about $11 billion) and there would be an eight percent reduction in non-defense discretionary spending. These examples are by no means a complete list. Percentage reductions in spending are nearly impossible to implement especially in defense spending. As Pentagon observers point out, "you can't cut two thirds of an aircraft carrier."

Given the complexities of federal budgeting and spending, it is unclear what the precise fiscal impact will be either in 2013 or over time. What is clear however is that the impact will result in a huge economic impact for the U.S. The Congressional Budget Office (CBO) estimates that if the combination of higher taxes and spending cuts as currently proposed are enacted, they would reduce the federal deficit by as much as $560 billion. At the same time, however, the plan would reduce the Gross Domestic Product (GDP) by four percentage points in just 2013. As first quarter annualized GDP was 1.9% and the GDP is tracking at or around 1.3% annualized for the second quarter, the result could be economically catastrophic.

The options for dealing with the problem range from doing nothing to falling off the fiscal cliff into recession. Doing nothing would be like punting the problem to a potentially new President and Congress when they take office in 2013. It obviously does nothing to solve the problem. Similarly, neither party wants to take responsibility for a devastating fall over the fiscal cliff. Additionally, striking a meaningful compromise before or after the election but before tax increases and spending cuts take effect seems equally implausible. The most plausible measure, in our view, would be modest compromise on tax increases and spending cuts.

The cost of in-decision is already weighing heavily on the economy. The uncertainty is likely to shave at least 0.5% off GDP growth for the year as consumers cut spending and businesses slow manufacturing and defer hiring.

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